

RatingsDirect®

Summary:

New Mexico; Miscellaneous Tax

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Credit Profile

US\$124.645 mil severance tax bnds ser 2018A due 07/01/2028		
<i>Long Term Rating</i>	AA-/Stable	New
New Mexico severance tax		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
New Mexico severance tax		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
New Mexico supplemental severance tax		
<i>Long Term Rating</i>	A+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA-' rating to the State of New Mexico's \$127.645 million severance tax bonds, series 2018A, and affirmed its 'AA-' rating on the state's \$855.075 million parity senior-lien severance tax bonds. At the same time, S&P Global Ratings affirmed its 'A+' rating on New Mexico's \$93.68 million subordinate supplemental severance tax bonds outstanding. The outlook on all ratings is stable.

A lien on money deposited into the severance tax bonding fund, including net tax receipts generated from natural gas, oil, and other severed natural resources in New Mexico, secure the senior severance tax bonds. The supplemental severance tax bonds are secured by a second lien on pledged revenues, after payment of senior debt service.

The ratings reflect our view of New Mexico's:

- Recent increase in pledged revenue as a result of higher oil and gas prices and increased production. Pledged revenue increased 12.2% in fiscal 2017. The state is projecting a further increase of 24.3% in fiscal 2018 and 8.2% in 2019, followed by small gradual declines thereafter through fiscal 2022.
- Strong 2.28x coverage of new senior-lien maximum annual debt service (MADS) after this sale, using fiscal 2017 severance tax revenue, and 2.83x coverage by state estimated fiscal 2018 pledged revenue. The state calculates debt service coverage (DSC) using additional pledged interest earnings and financing sources, which we calculate would produce higher senior-lien MADS coverage of 3.03x by estimated 2018 revenue.
- Good 1.99x coverage of combined senior- and subordinate-lien MADS by severance tax revenue alone in fiscal 2016.
- Declining debt service schedule after 2020 and rapid debt amortization, with all principal to be retired by 2028.
- Strong additional bonds tests (ABT) for both senior- and subordinate-lien bonds. State statute requires effectively a senior-lien coverage ABT rising from 2.07x MADS in fiscal 2017 to 2.10x MADS in fiscal 2019 and thereafter, and from 1.63x MADS to 1.66x MADS for combined senior and subordinate bonds, using the lesser of the current or previous year's pledged receipts.

Additional rating factors include what we consider:

- The inherent instability associated with natural gas and oil prices and production levels, which account for the bulk of pledged revenues. Previously, severance tax receipts declined 32% in fiscal 2010, before increasing 21% and 28% in 2012 and 2014, respectively, then again decreasing 8.4% in 2015 and 38% in 2016; and
- State geographic limitations in serving natural gas markets that might be distant from New Mexico, particularly as competing eastern shale gas production picks up near eastern coast markets, although natural gas accounts for only about 27% of total estimated 2018 state severance tax revenue.

We understand that the proceeds of the series 2018A bonds will be used to fund various state capital improvements.

New Mexico levies severance taxes on a variety of minerals. Oil (71% of state-estimated fiscal 2018 severance taxes), natural gas (27%), and coal (1%) are the major severance tax revenue generators. Carbon dioxide, copper, potash, and other minerals account for the balance. We calculate fiscal 2017 severance taxes produced strong, in our view, 2.28x coverage of new senior-lien pro forma MADS that occurs in fiscal 2020 after this sale, not including interest earnings or other financing revenues. We calculate fiscal 2017 severance tax revenues cover new combined senior- and subordinate-lien MADS by 1.99x. In addition, the state realized \$9.7 million of investment earnings in its bond fund in fiscal 2017 and \$9.4 million from other financing sources, consisting of reversions of unspent capital proceeds. Including interest earnings and other financing sources, we calculate senior-lien MADS coverage by 2017 total pledged revenue rises slightly to 2.41x, and combined senior and subordinate MADS coverage rises to 2.10x.

Following a 28% increase in severance tax revenue in fiscal 2014, severance taxes declined 8% in fiscal 2015, and declined another 38% in fiscal 2016, before increasing 12% in fiscal 2017. The state estimates 24% growth in fiscal 2018, while projecting 8% growth in 2019. Following that, New Mexico projects declines of 8% in 2020, 2% in 2021, and 2% in 2022. We believe that price increases in the last year and increased consumption for natural gas have been offset by new fracking and horizontal drilling technology, particularly in competing eastern shale fields located closer to population centers, that have caused the state to project gradually reduced sales of New Mexico natural gas, although natural gas represents only about 27% of total severance taxes. Consequently, pledged state revenue has gradually tilted toward a larger share of oil-derived severance tax. Oil rig counts have increased since 2016 and production is rising again. We believe historical fluctuations in severance tax highlight the inherent volatility of commodity prices and mining production, but in our opinion these are largely offset by strong coverage of debt service and a declining debt service schedule.

The estimated 24.3% severance tax growth in fiscal 2018 would raise senior-lien MADS coverage slightly to 2.83x, and combined senior- and subordinate-lien MADS coverage to 2.47x. We believe the state's oil price forecast of \$54.00 per barrel in fiscal 2019 and \$3.10 per thousand cubic feet (/mcf) is in line with our forecast (see "The North American E&P Sector Is Talking Cash Flow Growth and Capital Discipline, But Can They Execute?," published June 6, 2018, on RatingsDirect). New Mexico estimates state oil and gas prices at \$50.00 in 2018 and \$3.25 per mcf in fiscal 2018. Typically, New Mexico oil sells about 10% below benchmark Texas crude oil due to higher transportation costs, while its natural gas sells somewhat above benchmarks due to useable liquids typically contained within the state's natural gas.

The ABTs for the severance tax bonds restricts the state's ability to issue parity long-term debt. These tests and a "best efforts" pledge to maintain annual deposits in the bonding fund equal to 2.0x senior DSC and 1.6x supplemental DSC are positive credit factors, in S&P Global Ratings' opinion. State statute also limits debt issuance to an effective coverage test of 2.10x MADS in fiscal 2019 and afterward for senior debt, and 1.66x MADS for combined senior and subordinate bonds, using the lesser of the current or previous year's pledged receipts. Bond counsel has previously opined that these statutory ABTs cannot be reduced without an impairment of bond covenant. We believe the current ABT substantially constrains issuance of additional new money parity senior-lien debt without an upturn in available pledged tax revenue, although the state expects issuance in future years, which would still be possible in view of the current declining debt service schedule.

New Mexico can also issue temporary short-term supplemental severance tax notes with a lower coverage test. The state typically issues short-term severance tax-secured notes with a one-day maturity to the state treasurer to make funds available for capital projects that would otherwise flow to the state's permanent fund, although, based on statute, notes can be issued for longer periods as long as they mature within the fiscal year. New Mexico can spend severance tax revenue for capital projects through the issuance of these notes if pledged deposits cover total combined annual debt service of senior, subordinate supplemental, and short-term bonds by at least 1.07x. Based on statute, the state could spend severance taxes for capital projects midyear if the lesser of previous-year or current-year receipts covers all annual debt service by 1.07x in fiscal 2017 phased to 1.16x by fiscal 2022.

Pledged severance tax revenues are collected monthly. There is no debt service reserve; however, to release excess funds on the day before semiannual debt service is due, there must be a balance in the bond fund equal to the next two semiannual debt service payments.

Outlook

The stable outlook reflects our expectation that DSC will remain strong on senior-lien debt and good on subordinate-lien debt during our two-year outlook horizon as oil and gas prices stabilize, or recover, and a declining debt service schedule props up MADS coverage. We expect that, as debt rolls off, New Mexico will continue to issue additional debt, which will keep DSC near the ABT. However, we see DSC as protected from significant additional bonding due to what we view as good ABTs. We also expect natural gas and oil reserves will continue to be replenished to maintain sufficient production over the bonds' relatively short 10-year life, despite depressed oil and gas prices and the potential for future cyclicalities in severance tax revenues. Should MADS coverage fall materially below the ABTs, a negative rating action or outlook revision is possible. If we believe the long-term outlook for prices, production, and additional bonding would support future DSC levels that would remain substantially above the ABTs, which we don't believe will occur in the near term, we could raise the ratings.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found

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